MyStratWeekly

Market views and strategy

Ostrum ASSET MANAGEMENT

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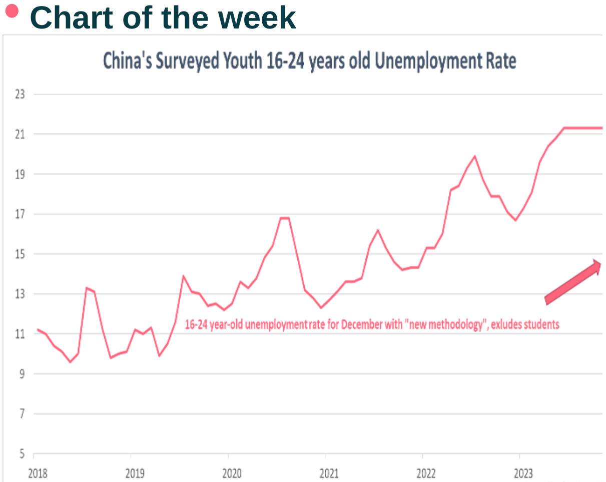
Topic of the week: Reform of EU budgetary rules

- **A reform was necessary to compensate for the lack of effectiveness of the previous budgetary framework, rarely respected, and to make it consistent with current conditions;**
- **The compromise reached by the 27 contains certain advances such as taking into account the specificities of each country and a more gradual adjustment of public debt;**
- **But the addition of specific and strict targets by so-called frugal countries limits the scope of the reform;**
- **Highly indebted countries will have to make a significant budgetary adjustment, at the risk of once again making these rules unworkable;**
- **This compromise is currently being negotiated by the European Parliament with a view to a desired vote before the European elections. Hopefully changes will be made to it to improve it.**

Market review: ECB : rate cut… next summer

- **Monetary easing to be delayed;**
- **T-note yields up to 4.15%;**
- **Credit spreads remain well oriented;**
- **Nasdaq rebound thanks to semiconductors.**

Chart of the week



A return with fanfare of the unemployment rate statistics of young people aged 16-24 in China which appears to have fallen to 14.9% in December 2023.

In June, the Chinese authorities suspended its publication in order to change the calculation methodology. Students are now excluded, which explains the sharp drop compared to the figure published in June 2023 of 21.4%.

China's statstics bureau has not published the history of the new series, making it difficult to apprehend the recent changes in youth unemployment.

Figure of the week

60

Source : IMF

This is the share of total employment in percentage in developed countries that will be exposed to artificial intelligence, according to an IMF study.

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● Topic of the week

Reform of EU budgetary rules

After years of reflection, then months of negotiations, the 27 finally agreed on a reform of the budgetary rules of the European Union. This proved necessary due to the lack of effectiveness of the previous framework and the fact that it was no longer adapted to current economic conditions. If progress has been made under the impetus of the European Commission and its proposals, the addition of binding safeguard clauses by so-called "frugal" countries limits the scope of this reform.

Essential budgetary rules in the EU

Budgetary rules are essential within the framework of a monetary union like the EU. The countries of the Eurozone in fact share the same currency, monetary policy being conducted by the ECB, while budgetary policies are defined by the member states. Rules are therefore necessary to coordinate national budgetary policies, adopt a fair balance between monetary policy and budgetary policy and avoid the appearance of excessively high deficits and public debts in certain countries, likely to weigh on the stability of the Eurozone.

In order to respect the criteria set out in the Treaties: a public deficit less than 3% of GDP and a public debt not exceeding 60% of GDP, countries must therefore respect a certain number of rules set out in the Stability and Growth Pact, adopted in 1997.

Limit of old budgetary rules

These rules turned out to be complex, procyclical, unworkable for certain countries and ultimately poorly respected, which weighed on the credibility of the pact.

Complexity of rules

They were based in particular on unobservable criteria such as achieving a medium-term structural deficit target of 0.5% to 1% of GDP. The latter is the negative budget balance excluding cyclical elements weighing on public finances. It is based on a measure of potential growth, that is to say long-term growth when all production factors are used and price stability is ensured. This growth measure is not observable and must be estimated. Results vary depending on the methods and assumptions used.

Procyclical rules

One of the limitations is the procyclical nature of these budgetary rules. When the country is in recession, the public deficit increases due to lower income, such as VAT revenue, and the increase in public spending to cushion the shock. However, budgetary rules amplify the shock, given that countries are required to reduce these imbalances at the cost of lower public spending and, often, to the detriment of public investment, which is nevertheless necessary for long-term growth.

Unworkable adjustment for highly indebted countries

The old rules stipulated that countries with public debt to GDP above 60% had to reduce excess debt by 1/20th per year. This constituted far too significant an adjustment for certain countries, with for example a reduction of 4% of GDP per year for Italy in particular, making the rules inapplicable.

Ineffective rules

These rules did not make it possible to avoid the sovereign debt crisis (in 2010-2012), leading the ECB to react quickly under the aegis of President Mario Draghi, giving rise to the now famous three words: "whatever it takes", delivered during a speech in July 2012, when the risks of a breakup of the Eurozone had become significant. Mario Draghi said the ECB would do everything it could, within its mandate, to preserve the integrity of the Eurozone, adding "believe me, it will be enough". This was followed by the announcement of a new instrument (OMT), which never needed to be activated, its mere existence proving effective. This allows the ECB to buy government bonds, on the secondary market, under strict conditions.

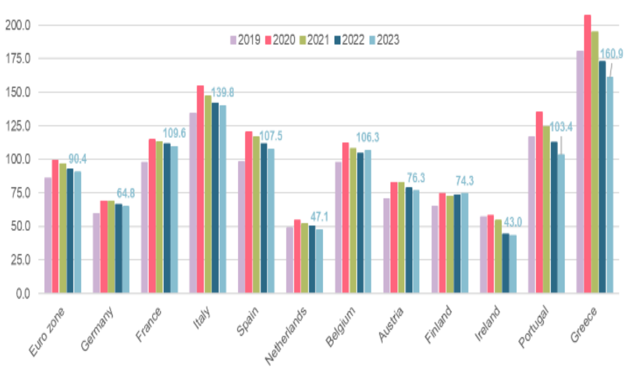
Credibility problem

There was also a problem of credibility since no country was sanctioned for non-compliance with the rules, while the Stability and Growth Pact stipulated the adoption of sanctions in the case of excessive public deficit and non-adoption measures required to reduce it.

Rules not adapted to the current situation

Furthermore, public debts have increased significantly since 1997, and much more with the Covid-19 crisis, which makes the rules of the stability and growth pact not adapted to the current situation, requiring rapid and unfeasible adjustment for a large number of countries. According to the European Commission, the debt of the Eurozone was on average in 2023 90% of GDP compared to 73% in 1997, with very heterogeneous levels.

Public debt to GDP ratio - EC forecasts in 2023



Sources : Datastream, Ostrum AM

Need for reform

Adjustments have been made since 1997, but they have proven insufficient. The suspension of budgetary rules since 2020, to deal with the Covid-19 crisis and then the energy crisis, constituted the opportunity to reform them, before their reinstatement from January 1, 2024.

Agreement of the 27 on a reform of budgetary rules

The criteria set out in the Treaties of public deficit less than 3% of GDP and public debt not exceeding 60% of GDP are maintained. What is evolving is the means to achieve this: the Stability and Growth Pact. Two essential points of the agreement take up the proposals of the European Commission from April 2023.

Differentiated approach by country

Rather than following common targets and therefore unsuitable ones for different countries, the reform takes into account the specificities of each country such as the ratio of deficit and public debt in relation to GDP, growth, etc.

Multi-annual budgetary trajectories specific to each Member State will be determined. They will be based on an analysis of debt sustainability carried out by the European Commission. Countries will have to present medium-term budgetary and structural plans, 4 to 5 years, and commit to following a budgetary trajectory over this period and carrying out the necessary reforms and investments. This differentiated approach depending on the economy will make the application of the rules more feasible.

The EC will determine a “technical trajectory” for countries exceeding the 3% or 60% thresholds

For countries with a public deficit to GDP ratio above 3% or public debt to GDP ratio above 60%, the EC will determine “a technical trajectory” of net spending. This will be such that at the end of the four-year budgetary adjustment period, the public debt will “possibly” be on a downward trajectory or remain at a level below 60% in the medium term and the public deficit must be reduced and maintained below the threshold of 3% of GDP in the medium term.

A single indicator: the trajectory of public spending

These are public expenditures excluding interest charges and cyclical elements. When a country exceeds the threshold of 3% public deficit relative to GDP or 60% public debt to GDP, the EC will send it a trajectory of net public spending over 4 years. This aims to make this framework less procyclical than it was before.

Possible extension of the adjustment period to 7 years

Countries can request an extension of the fiscal adjustment period to 7 years, compared to 4 years otherwise, if they commit to adopting reforms and making investments in favor of sustainability and growth. Those carried out under the Recovery and Resilience Facility will be taken into account.

Maintaining the rules regarding the excessive deficit procedure

The trajectory of net spending must be compatible with a minimum annual structural adjustment of the deficit of 0.5% of GDP.

Transitional period in 2025, 2026 and 2027

The increase in the interest charge will not be taken into account in the calculation of the adjustment to be made under the excessive deficit procedure.

Lesser fine

In the event of non-compliance with budgetary rules, the fine could reach up to 0.05% of GDP every 6 months, which would accumulate until effective action is taken.

Exemption clauses

The general exemption clause at EU level has been maintained in the event of a significant slowdown in activity. It was used during the Covid-19 crisis and then extended during the energy crisis to allow governments to take budgetary measures aimed at cushioning the unprecedented shock to growth.

A national derogation clause has been added in case of exceptional circumstances. This aims to reduce the procyclical nature of the measures.

Monitoring

Independent bodies, such as the European Budgetary Committee, will monitor compliance with the rules.

Addition of two saving clauses

So-called "frugal" countries, including Germany, insisted on adding stricter rules with very specific targets to avoid maintaining excessively high deficits and debts.

Debt sustainability rule

Countries with a public debt ratio above 90% of GDP will have to reduce excess debt by at least 1 percentage point of GDP per year on average over the adjustment period. Countries with debt between 60 and 90% of GDP will need to reduce excess debt by at least 0.5 percentage points of GDP per year on average. Previously, the requested adjustment was 1/20th of excess debt per year, which was unachievable for highly indebted countries.

Deficit Resilience Rule

Countries must continue budgetary adjustment until they reach a common safety margin of a public deficit of 1.5% of GDP below the threshold of 3%. This requires an annual reduction in the structural primary balance of 0.4% of GDP or 0.25% of GDP in the event of an extension of the adjustment period.

A half-hearted reform

The objective of this reform was in particular to simplify the EU budgetary rules, make them less procyclical, set more realistic objectives and allow greater appropriation of the rules by member countries. In the end, the new rules seem just as complex, if not more so, due to the addition of rules for mathematically reducing imbalances on the part of frugal countries.

The positive points lie in a more gradual adjustment of the debt-to-GDP ratio of countries subject to an excessive deficit procedure and in taking into account their own situation. They have the possibility to request a longer adjustment period on the condition that investments and reforms are made to ensure sustainability and growth. Budgetary rules are thus less procyclical.

The transitional period between 2025 and 2027 is welcome: it will make it possible not to take into account the increase in the debt burden in the calculation of the adjustment to be made as part of the excessive deficit procedure. The national safeguard clause is also a positive element aimed at making the required adjustment less procyclical.

On the other hand, the safety margin targeting a public deficit of 1.5% of GDP is too strict for the most indebted countries. According to an analysis by Bruegel[1], the annual budgetary adjustment to be made

[1] https://www.bruegel.org/first-glance/assessing-ecofin-compromise-fiscal-rules-reform

for Italy would be significant. The primary structural balance should improve by 1.15% per year if the adjustment is done over 4 years and by 0.61% if it is done over 7 years. If the adjustment is made over 7 years, 5 countries in the Eurozone will have to improve their structural budget balance by more than 0.4% per year. Which is a significant effort.

Conclusion

EU budgetary reform appears to be mixed. Taking into account the specificities of each country, a more gradual adjustment of the debt-to-GDP ratio and the national derogation clause constitute positive points. On the other hand, the addition of the two safeguard clauses with strict targets complicates the rules and removes the flexibility that prevailed in the European Commission's proposal. The adjustment of structural primary deficits will be important for the most indebted countries, otherwise there is a risk that the rules will not be respected. Negotiations have started in the European Parliament with a view to adopting the reform before the European elections and their implementation in 2025. Let us hope that adjustments will be made.

Aline Goupil-Raguénès

Market review

ECB : rate cut… next summer

The prudence of central banks is pushing up bond yields but without harming risky asset markets.

The words of caution from central bankers finally seem to be influencing market expectations for policy rates. Rate cuts should not take place before the summer according to Christine Lagarde's message from Davos. The monetary relief projected by the markets actually complicates the ECB's fight against inflation. Successive shocks to world trade threaten to cause the inflation of imported goods to rise again. On the Fed side, Christopher Waller has softened his message since the late October pivot. Raphael Bostic, voting member of the FOMC in 2024, indicates that a premature cut creates a risk of rates rising if inflation persists. Bond yields have rebounded as US data releases point to continued sustained growth. The greenback benefits from the strong growth backdrop, without prejudice to risky assets which found support in the sales guidance of TSMC which impacted by the entire US technology sector. When the Nasdaq rises, Western markets follow. A change in the stock-bond correlation is taking place so that upward pressure on long-term bond yields are no longer holding back stocks. On the other hand, the lackluster Chinese data accentuates the downward pressure on the Hang Seng stock index, which has plunged 10% since the start of the year.

Economic publications remain well oriented in the US. Retail sales (+0.6% in December) echo the previous rebound in consumer credit. The further drop in initial jobless claims to 187k demonstrates the strength of the job market even if announcements of layoffs have been made in the banking and technology sectors. These announcements aim at reassuring investors about the prospects for profitability rather than warning of a change in the growth outlook. The housing sector is finding support in the recent fall in mortgage rates. Home builder confidence is improving (NAHB at 44) and housing starts should follow. In China, growth (1% in the 4th quarter) remains weighed down by real estate and less dynamic consumption than expected. Unambitious fiscal support plans follow one another without succeeding in reversing the economic growth downtrend, especially as deflation sets in. In the euro area, Germany recorded annual contraction in its GDP of 0.3% in 2023. Current discussions in Parliament should lead to a budget bill in February but without significant stimulus for the ailing German economy.

The prudence of central banks is not having quite the expected impact on the fixed income markets. Certainly, long-term bond yields are rising (4.15% on the T-note) but the flattening of the yield curve remains subdued. The 2-10 spread in euro bond markets nevertheless tightened by around 6 bp with Schatz yields around 2.70%. The first rate cut is being postponed but the expected speed of adjustment, once the monetary cycle will have started, remains close to a cut at each meeting. However, this linear reduction fits poorly with the risks of a rebound in inflation and cyclical recovery. The primary market remains lively, particularly the sovereign, supranational and agency debt markets. The main sovereign bond syndication of the week was the triple tranche of Austrian debt worth €7 billion. The French inflation-linked debt issuance were well received, as was the new 10-year TIPS in the United States. Investors are seeking to hedge against the risk of a resurgence of inflation. Brent prices remain close to $80 with tensions in the Red Sea and the drop in US oil inventories. Thus, the 10-year inflation breakeven point rose to 234 bp.

Euro credit spreads tighten slightly to 96 bp against swaps or 138 bp against Bunds. The primary bond issuance is generally well absorbed by the market, despite competition from government bonds. New bond deals will decrease during the upcoming earnings season. The more constructive environment for risky assets also benefits high yield. The asset class is also less sensitive to rising rates. The average spread stands at 342 bp against swaps. The previous tightening shifts investor interest to the lowest ratings, including ailing real estate companies. The improvement is much less clear on US high yield.

The stock market is resisting the strong dollar and rising bond yields. That being said, the rebound in technology in the United States masks a majority of declining sectors and a sharp pullback in Chinese indices.

Axel Botte

Main market indicators

G4 Government Bonds	22-Jan-24	1wk (bp)	1m (bp)	2024 (bp)
EUR Bunds 2y	2.68%	+8	+25	+27
EUR Bunds 10y	2.28%	+4	+30	+25
EUR Bunds 2s10s	-40.4bp	-4	+5	-2
USD Treasuries 2y	4.37%	+22	+4	+12
USD Treasuries 10y	4.08%	+14	+19	+20
USD Treasuries 2s10s	-28.5bp	-8	+14	+9
GBP Gilt 10y	3.87%	+7	+36	+33
JPY JGB 10y	0.66%	+9	-12	-7
€ Sovereign Spreads (10y)	**22-Jan-24**	**1wk (bp)**	**1m (bp)**	**2024 (bp)**
France	49bp	0	-4	-4
Italy	154bp	-3	-13	-13
Spain	91bp	-1	-5	-5
Inflation Break-evens (10y)	**22-Jan-24**	**1wk (bp)**	**1m (bp)**	**2024 (bp)**
EUR 10y Inflation Swap	2.14%	-1	0	+1
USD 10y Inflation Swap	2.5%	+2	+7	+9
GBP 10y Inflation Swap	3.51%	-1	-4	-2
EUR Credit Indices	**22-Jan-24**	**1wk (bp)**	**1m (bp)**	**2024 (bp)**
EUR Corporate Credit OAS	136bp	-4	-3	-2
EUR Agencies OAS	68bp	-1	-3	-2
EUR Securitized - Covered OAS	74bp	-3	-5	-4
EUR Pan-European High Yield OAS	377bp	-5	-24	-22
EUR/USD CDS Indices 5y	**22-Jan-24**	**1wk (bp)**	**1m (bp)**	**2024 (bp)**
iTraxx IG	59bp	-1	0	+1
iTraxx Crossover	323bp	-4	+3	+10
CDX IG	55bp	0	-1	-2
CDX High Yield	353bp	0	-4	-3
Emerging Markets	**22-Jan-24**	**1wk (bp)**	**1m (bp)**	**2024 (bp)**
JPM EMBI Global Div. Spread	400bp	+1	+16	+16
Currencies	**22-Jan-24**	**1wk (%)**	**1m (%)**	**2024 (%)**
EUR/USD	$1.089	-0.566	-1.144	-1.4
GBP/USD	$1.272	-0.039	0.165	-0.1
USD/JPY	JPY 148	-1.387	-3.634	-4.6
Commodity Futures	**22-Jan-24**	**-1wk ($)**	**-1m ($)**	**2024 (%)**
Crude Brent	$79.7	$1.6	$0.9	3.5
Gold	$2 025.0	-$31.6	-$28.1	-1.8
Equity Market Indices	**22-Jan-24**	**-1wk (%)**	**-1m (%)**	**2024 (%)**
S&P 500	4 857	1.53	2.15	1.8
EuroStoxx 50	4 482	0.62	-0.87	-0.9
CAC 40	7 423	0.15	-1.93	-1.6
Nikkei 225	36 547	1.80	10.18	9.2
Shanghai Composite	2 756	-4.50	-5.44	-7.3
VIX - Implied Volatility Index	13.51	6.38	3.68	8.5

Source: Bloomberg, Ostrum AM

Additional notes

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